

LENDER LIABILITY AND THE FTC HOLDER RULE

By Frederick L. Miller

Lender or assignee liability for the actions of the seller is essential for the protection of consumers in many situations. Consumer issues frequently come up in defense of collection actions brought by finance companies and banks. While immediate sellers can be brought into the cases, many times they are out of business or uncollectible. Without lender liability for claims assertable against the seller, the consumer will be stuck.

If the financing company is an assignee of an installment sales contract entered into with the seller, there are many sources of law supporting the liability of the assignee for claims and defenses available against the seller. To begin with, the holder-in-due-course rule of UCC Article 3, MCLA 440.3302 and 440.3305(b), which is asserted to protect assignees, doesn't apply, since the transaction doesn't fit the definition of a negotiable instrument. MCLA 440.3104(a). As a result, holder-in-due-course protections shouldn't be available to the assignee.

In addition, various state consumer statutes enforce assignee liability for most consumer contracts. See, e.g. MCLA 445.865 (Retail Installment Sales Act); MCLA 492.114a (Motor Vehicle Sales Finance Act); MCLA 445.1207 (Home Improvement Finance Act).

Finally, the Federal Trade Commission (FTC) Rule on the Preservation of Claims and Defenses, 16 CFR 433, requires contract language in financed consumer sales which abrogates any protections available for the assignee. This language, when written into the installment sales contract as required, becomes enforceable as a contract term,

making the assignee liable for claims and defenses that could be asserted against the seller that assigned the contract.

However, consumer finance arrangements are often written as direct loans from a bank or finance company rather than an installment sale assigned to the finance company after the sale. The seller may act as agent for the financing company, arranging the loan, or may send the buyer to the finance company office. With these arrangements, assignee liability provisions of Michigan consumer statutes may not apply to make the finance company liable for the actions of the seller. On paper, there is no installment sale, but a direct loan, usually secured, from the bank or finance company.

The buyer is left with two sources of law to keep the finance company from profiting at the expense of the bilked consumer: 1) the FTC Rule provisions on liability of related lenders, and 2) common law theories of joint action, agency, fraud or negligence.

The FTC Rule on Preservation of Claims and Defenses has a second notice requirement, in addition to the notice required in installment sales contracts, to be placed in certain loan agreements for purchase of consumer goods and services. This notice is required when there is a referral, affiliation or business arrangement between the seller and the lender. The notice subjects the lender to claims and defenses available against the seller, again as a matter of contract agreement.

Installment sales agreements entered into with sellers typically have the required FTC holder liability language. However, purchase money loans entered into directly with finance companies and banks often don't, even when the language is required due to the referral relationship between the lender and the seller. Two problems arise for the

consumer attorney trying to enforce the FTC Rule requirements when the language is not in the loan agreement: 1) the FTC rules do not give rise to a private right of action; and 2) the Rule on Preservation of Claims and Defenses does not require the lender to put the appropriate language in the loan agreement, but only requires the seller not to accept proceeds of the loan if the language is not there.

Consumer attorneys have typically used state consumer statutes to enforce the FTC rules, in lieu of a private right of action directly under the Federal Trade Commission Act. Some state consumer laws directly incorporate FTC determinations of unfair and deceptive acts and practices. This is not true of the Michigan Consumer Protection Act.

However, several sections of the MCPA may be violated by the lender's failure to put the claims and defenses language in the loan agreement. These include:

- a). "Causing a probability of confusion or of misunderstanding as to the legal rights, obligations, or remedies of a party to a transaction", MCLA 445.903(1)(n).
- b) "Causing a probability of confusion or of misunderstanding as to the terms or conditions of credit . . ." MCLA 445.903(1)(o).
- c) "Failing to reveal a material fact, the omission of which tends to mislead or deceive the consumer, and which fact could not reasonably have been known by the consumer," MCLA 445.903(1)(s).

These sections impose a duty on the lender not to mislead the consumer. If there is a referral or other business arrangement between the seller and the lender, the lender is misleading the consumer if the consumer is not notified of the required FTC language.

The existence of the referral or business arrangement, and its impact on the obligations and rights of the parties, are material facts that have not been disclosed to the consumer.

No Michigan cases have yet addressed enforcement of FTC consumer rules through the Michigan Consumer Protection Act. There are a few useful cases from other jurisdictions. The Court in **Heastie v Community Bank of Greater Peoria**, 727 F Supp 1133 (ND Ill 1989), read the Illinois Consumer Fraud Act broadly to impose liability on a bank for using a form which contained language contradicting the FTC Claims and Defenses Rule. In **Brown v LaSalle Northwest National Bank**, 820 F Supp 1078 (ND Ill 1993), the Court held that a bank's practice of leaving the FTC language out of contracts involving car dealers with which it had a business or referral arrangement could form the basis for an action under the federal RICO statute. As the Court stated, “. . . the defendant can be part of a scheme to defraud consumers even if the regulation does not directly apply to lenders.” **Brown**, at 1081.

The **Brown** case gives support for asserting common law fraud as well as Consumer Protection Act violations against a lender which ignores the FTC Rule in its contracts. Additional grounds for this claim, and for a negligence claim, may be found if the lender knew or had reason to know of unfair business practices of the seller. In **Estate of Sheradsky v West One Bank**, 817 F Supp 423 (SDNY 1993), the bank had information suggesting that the investment program that plaintiffs and others were borrowing money to invest in was a pyramid or “Ponzi” scheme. The Court held that the bank could be liable for the plaintiffs' losses. The Court cited “the perceptions underlying” the FTC Rule as support for this proposition, and stated, “If fraud is involved

in a transaction, a financing entity which deliberately shuts its eyes to clues concerning the fraud may be unable to enforce promissory notes signed as a result of the fraud”.